No. 12973

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

SHAFFER TERMINALS, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

UPON PETITION TO REVIEW A DECISION OF THE TAX COURT OF THE UNITED STATES

PETITION FOR REHEARING

HENRY C. PERKINS,
FREDERIC D. METZGER,
Attorneys for Petitioner.

METZGER, BLAIR, GARDNER & BOLDT,
Of Counsel.

Office and Post Office Address:
523 Tacoma Building
Tacoma 2, Washington

Dammeier Printing Co.

INDEX

TABLE OF CASES

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

SHAFFER TERMINALS, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR REHEARING

Petitioner respectfully petitions this Court for a rehearing of this cause, because of its conviction that the decision is erroneous under the undisputed facts and the law applicable thereto, and because the issue here is such that a rehearing by this Court affords the only real remaining means whereby Petitioner may secure redress from the injustice of the tax liability which will be otherwise imposed upon it.

The grounds upon which Petitioner seeks a rehearing are:

1. This Court adopted the reasoning and tacitly approved findings of the Tax Court which were based wholly upon inference and implication drawn from undisputed testimony and clearly erroneous.

2. This Court erroneously held that the facts of this couse bring it within *Armston v. Commissioner,* 188 F.(2d) 531 (CCA 5th) and *White v. Fitzgerald,* 193 F.(2d) 398 (CCA 3rd). It is clearly distinguishable therefrom upon its determinative facts, and falls unmistakably within the ruling facts in *Commissioner v. Greenspun,* 156 F.(2d) 917 (CCA 5th), and *Twin Oaks Co. v. Commissioner,* 183 F.(2d) 385 (CCA 9th).

4. The Court erroneously treated the transaction as a "sale and lease-back," when in reality it was only a lease. cf P-H 1952 Tax Service, Vol. 1, Par 12,011 and Par. 12,011-A.

5. The Court failed to recognize the business basis for the transaction and erroneously treated it as a transaction without business purpose, entered into solely for the purpose of evading taxes.

I.

SCOPE OF REVIEW

Because of colloquy between one of the judges and counsel for the Respondent during oral argument, and further because of the nature of the opinion filed by the Court in this cause, we believe that the Court may have misconceived the scope of its proper review of the findings and decision of the Tax Court. Under Internal Revenue Code, Section 1141(a), this Court's jurisdiction to review the decision of the Tax Court is the same as in review of decisions of the District Courts in civil actions tried without a jury. It is governed by Rule 52(a) of the Federal Rules of Civil Procedure. This Court so held in *Grace Bros. v. Commissioner*, 173 F.(2d) 170 (CCA 9th), and in that opinion said:

> "It is axiomatic that uncontradicted testimony must be followed. . . . The only exception to the rule occurs when we are dealing with testimony by witnesses who stand impeached and whose testimony is contradicted by the testimony of others or by physical or other facts actually proved, or with testimony which is inherently improbable."

Where evidence before the Court is undisputed and the disposition of the case must rest upon inferences or conclusions drawn from such testimony, this Court is as able as the Tax Court to draw the proper infer-

ences and conclusions and is free to do so, within the limits of giving due respect to the Tax Court's expertness in tax matters. *Gillette's Estate v. Commissioner,* 182 F.(2d) 101 (CCA 9th).

The only evidence in this case is that of Petitioner, and the evidence is undisputed. The ultimate question is whether rentals paid by Petitioner for use of equipment to a partnership had a business purpose and were therefore a deductible business expense under IRC Section 23(a)(1)(A), or whether the rental payments were made as a result of a transaction that in its entirety was a sham and indulged in only for the purpose of evading taxes. Since the proper conclusion must necessarily be predicated upon inferences and implications drawn from the undisputed facts, this Court in the exercise of the proper scope of its appellate jurisdiction should review the facts and draw therefrom its own conclusion.

II.

NATURE OF THE TRANSACTION

The answer to the ultimate question in this case may be readily and validly found by determining which of two decisions of the Fifth Circuit more closely fits the facts of this case.

Commissioner v. Greenspun, 156 F.(2d) 917 (CCA 5th), involved the question of the allowance as business expense, to a corporation solely owned by one Greenspun, of rentals or royalties paid to family trusts of the shareholder for the use of cylinders or drums used by the taxpayer in its business of manufacturing and selling carbonic acid gas. Prior to 1917, the cylinders were owned by Greenspun and others, who leased them to the corporation. In 1918 Greenspun acquired the interest of the other parties in the cylinders and sold them to the taxpayer. In 1919, after Greenspun became the sole stockholder, he bought the cylinders back and released them to the corporation. In 1931 Greenspun created family trusts and transferred all of his right and interest in the cylinders to the trusts, which continued to lease them to the taxpayer. The trustee was a subordinate employee of the taxpayer. In the years in question, 1938, 1939 and 1940, taxpayer paid large amounts to the trusts as rent or royalties for use of the cylinders. The Court held that the rentals in reasonable amounts were properly deducted as business expense. As Respondent properly observed in his brief, (Page 24), that Court held the unreality of the transaction lay not in the corporation leasing the cylinders, but in the 1918 transfer of title to it, and that the transfer back to Greenspun in 1919 merely restored the status quo. (See Op. 156 F.(2d) at page 921).

The case of *Armston v. Commissioner,* 188 F.(2d) 531 (CCA 5th), was a case where the taxpayer corporation, which was principally engaged in construction work, owned equipment purchased in the years 1940, 1941 and 1942 and thereafter used in its business. In 1943 it sold a part of this equipment to the wife of its principal shareholder. At the time of the transaction, the corporation had surplus and undivided profits amounting to $278,371.16, and the sale price of the equipment was $33,667.36. The Court held that the rentals were properly regarded by the Tax Court as distributions to Mrs. Armston of corporate earnings for the purpose alone of forming the basis for a substantial tax deduction to the corporation, and that it was merely a device for minimizing tax liability, with no legitimate business purpose. The corporation in this sale and lease-back transaction really gave up nothing but the income.

In the instant case, the taxpayer corporation had been for many years prior to the tax years in question engaged in the business of operating marine terminals under lease. With the advent of World War II, in 1942, it became necessary to conform to the established trend in that business of using pallet boards and fork lift trucks in handling cargo. The corporation did not own such equipment, the uncontradicted testimony being that "We had one ancient type fork-lift truck but

had no other equipment of that type." (R. 117). Taxpayer rented lift trucks from the United States Army and others. As of September 30, 1943, the shareholders of Petitioner formed a partnership in which their interests were equal and in very different proportion than their share holdings. The Partnership acquired and rented to the corporation lift trucks costing $9,529.44. Subsequently it purchased and rented to the corporation additional equipment of this type, the Partnership paying $10,298.60 for such equipment in March of 1944, and an additional $10,319.61 in June of 1945. True it is that the corporation was a transitory conduit of title. It applied for the necessary priorities to purchase the equipment, because it could expeditiously obtain them, and payment was made to the vendor by checks of the corporation, but in each instance the Partnership gave its check to the corporation for the purchase price prior to the time the corporation's checks were presented for payment. (R. 23). The reason for this arrangement was fully and validly explained as being due to the greater expedition and certainty of obtaining the equipment in this manner. There is no dispute but that the corporation never owned the equipment while it was used and that the purchases were in actual reality made by the Partnership with funds contributed by the partners or obtained upon the credit of the individual partners and the security of its assets.

It is apparent that this was not a situation where the corporation sold equipment to the partnership and leased it back. Looking at the entire transaction, it was in reality and in substance a purchase by the Partnership of equipment of a type that the corporation never owned but had theretofore leased. The corporation merely continued its established practice of obtaining such equipment for its use by leasing the same. Much is said about the fact that the corporation paid rentals to the partnership for the use of this equipment in the years 1943, 1944 and 1945 in the aggregate amount of $77,461.78. As the Court of Appeals of the 5th Circuit properly pointed out in *Commissioner v. Greenspun,* 156 F.(2d) 917, this undoubtedly has a bearing upon the question of whether the rental paid was to the full amount a legitimate business expense, but has nothing to do with the question whether reasonable rental was a properly deductible business expense. There is no question raised in this case as to the reasonableness of the rental, and there can be none, because the rental was at the same rate as the Petitioner paid to others for like equipment and was at the rates established by the regulatory authority of the State of Washington. It is of compelling significance that during the same years, 1943, 1944 and 1945, Petitioner paid to the United States Army for the rental of similar equipment the sum of $73,585.50, and in the years 1943 and 1944 paid

to others than the United States Army for the rental of similar equipment the sum of $14,192.75. (R. 33, 34).

There is here no question but that the Partnership had a valid existence; that it became the owner of the equipment; that the rentals were paid in due course of business; that the money and credit used by the Partnership was its own and not that of the corporation; that the corporation was used only as a temporary conduit of title in acquiring the equipment and in reality was never the owner thereof so far as tax significance is concerned; and that it never used the equipment during the brief period of days while it acted as a conduit of title.

The underlying basis for the decision in *Armston v. Commissioner, supra,* and other so-called "sale and lease-back" cases, is that the transaction in its entirety constituted only a re-allocation by the corporation of income theretofore enjoyed and which it would have continued to enjoy had not the questioned transaction been entered into. The result reached in that case is predicated upon a finding, properly drawn from the evidence, that there was no business purpose to the corporation in entering into the transaction, and no purpose for it other than to obtain a re-allocation of its income for the purpose of avoiding taxes. There was no re-allocation of income here. Petitioner had not

owned equipment of this type and had never received the income. Had the United States Army and others continued to make such equipment available to Petitioner on a rental basis, Petitioner would have continued to rent from the Army and others at the same rates it paid the Partnership. It was only because the equipment became unavailable on the rental market that Petitioner turned to the Partnership as a means of finding an owner with equipment available to it for rental. The facts bring the case squarely within *Commissioner v. Greenspun* and clearly differentiate it from *Armston v. Commissioner.*

III.

BUSINESS PURPOSE

We are satisfied that the distinction between a lease case, such as *Commissioner v. Greenspun,* and a sale with lease-back case, such as *Armston v. Commissioner,* should be dispositive of this case, because here there is no basis for asserting that the taxpayer re-allocated its income for the purpose of avoiding taxes. But assuming for purpose of argument that this was a sale and lease-back transaction, the rentals are none the less deductible, because here there was a business purpose for the transaction. It should be borne in mind that the

business purpose need not rest upon unquestionably sound business judgment. Suffice it that there was a purpose other than merely to avoid taxes. The distinction is between sham and substance.

Neither the Tax Court nor counsel for Respondent in presenting the case to this Court have fairly interpreted the financial position of Petitioner. The tax returns of Petitioner for the years 1944, 1945 and 1946 are a part of the record. They disclose the following financial results of Petitioner's operations for those years:

1944

Adjusted net income	$42,362.49	(R. 38, L. 38)
1944 income and excess profits taxes	25,185.99	(R. 60, Sch. M, L. 3)
Net earnings after taxes	$17,176.50	

1945

Adjusted net income	$28,309.81	(R. 56, L. 38)
1945 income and excess profits taxes	15,237.32	(R. 74, Sch. M, L. 3)
Net profit after income and excess profits taxes	$13,072.49	

1946

Adjusted net income (Deficit)	($15,843.62)	(R. 70, L. 35)

The profits remaining after taxes for these three years of operation were then as follows:

1944	$17,176.50
1945	13,072.49
1946	(15,843.62)
Net income after taxes for three-year-period	$14,405.37

Bearing in mind that the purchase price of the lift trucks bought by the Partnership was in excess of $30,000.00, it is at once apparent that the earnings of the corporation for the three-year-period would have paid less than half of the purchase price.

As disclosed by the 1944 return, Petitioner's earned surplus and individed profits at the beginning of the year 1944 were in the amount of $83,219.31, but its tax liability for 1943 was $54,554.15, which, when deducted, left a surplus and undivided profit of $28,665.16.

Earned surplus and undivided profits as of January 1, 1945, were $67,303.28, but it had a 1944 tax liability of $25,185.99, leaving earned surplus and undivided profits of $42,117.29.

As of January 1, 1946, its earned surplus and undivided profits were $68,922.29, against which it had a

1945 tax liability of $15,237.32. The earned surplus and undivided profits at the close of 1946 were $31,836.64.

At the close of 1943, Petitioner was using borrowed capital in the amount of $32,000.00 (R. 37), and at the close of 1944, it owed the bank $52,000.00. (R. 37). Its average loans in 1944 were $36,125.00 (R. 55), and in 1945, $21,980.00. (R. 69). These loans were, of course, included in Petitioner's liabilities in determining its net worth. They are significant and disclose the extent of the use by Petitioner of the limited credit available to it.

Petitioner's gross receipts in 1944 were $496,494.16 (R. 38, L. 4), and in 1945, $391,531.88. (R. 56, L. 4). Since its profit for these years was nominal, it follows that Petitioner was incurring obligations in substantially the amounts of its gross revenues, which averaged more than $1,350. 00 per day in 1944, and more than $1,000.00 per day in 1945.

The foregoing figures give substance and meaning to the statement of Mr. Searles, Vice President of The Puget Sound National Bank, that the corporation was not entitled to credit to be used for the purpose of purchasing capital assets such as equipment. Its working capital necessities required the use of its available

credit. They completely negative the significance which the Tax Court attributed to the amount of Petitioner's bank balance on particular dates.

It is undisputed and not subject to question that the officers of Petitioner discussed with Mr. Searles the matter of Petitioner obtaining a loan to buy the equipment; that he discouraged them; and that he would not recommend to his employer a loan to Petitioner for such a purpose, and without his recommendation, such a loan would in all probability be rejected. Aside from the views of Mr. Searles, it was entirely proper for the officers of Petitioner to determine that it was better for Petitioner to continue to rent this type of equipment rather than undertake the burden of acquiring it outright. Its decision to continue to lease had a proper business purpose and background. From this background a conclusion that the only reason for entering into the transaction with the Partnership was to re-allocate its income for the purpose of evading taxes cannot obtain any substantial support.

Respondent would probably challenge the foregoing analysis from the record of Petitioner's financial situation with the confident assertion that the picture would have been entirely different if Petitioner had not paid out $77,461.78 in rental to the Partnership during the

years 1943, 1944 and 1945. Such an assertion would be wholly fallacious.

Much was said in Respondent's brief and in argument about the ability of taxpayer to have paid for the lift trucks bought by the Partnership rather than paying rentals, since the amount of rentals exceeded the purchase price. This argument is wholly superficial and unrealistic. Had the corporation purchased the equipment and thereby increased its adjusted net income by the amount of rentals paid, the amount of such increased income would have been subject to income and excess profits taxes in excess of 85%. This would have meant that of the total rentals, less than 15%, or less than about $10,500.00, would have been left to Petitioner to apply on the purchase price of $30,000.00.

In conclusion, we respectfully submit:

A. That this Court must draw from the undisputed facts its own conclusion as to whether this transaction was a mere sham, engaged in solely for the purpose of evading taxes.

B. That the transaction in reality and in substance was simply a lease transaction between two distinct entities, where the only question could be as to the reasonableness of the amount of rentals paid.

C. That even though this Court take the unrealistic view that it was a sale with lease-back arrangement, there was a business reason established by uncontradicted testimony which gives to the form of the transaction substance and validity.

This petition should be granted, and the case set for reargument, to the end that the issues will be reheard and reconsidered by this Court and the judgment of the Tax Court reversed.

Respectfully submitted,

HENRY C. PERKINS,
FREDERIC D. METZGER,
Attorneys for Petitioner.

METZGER, BLAIR, GARDNER & BOLDT,
Of Counsel.